

Managing the DB pensions legacy

Options for companies

November 2006

Companies are increasingly viewing their defined benefit pension scheme as a legacy issue and a major corporate finance headache, due to the potential impact on the overall balance sheet. To date, the options for managing this legacy out in an aggressive way have been very limited, but this may be changing. This bulletin summarises the emerging trends.

Background

In the past, the only way of removing defined benefit liabilities has been a traditional bulk buy-out.

Over the last few years, there have only been two main players in the UK for this type of business, Legal & General and Prudential. As a result, this option has been expensive, and has not been available to large schemes (over around £1 billion).

Recent changes – the bulk buy-out market

New entrants to the bulk buy-out market are emerging, which may provide options for companies that have previously dismissed buy-out as too expensive, or where the liabilities were too large to be placed within the market.

In addition, a number of providers are offering other methods of managing out the DB legacy. This is a rapidly developing market, and the pace of change is evidenced by an increasing number of press headlines.

Examples of opportunities being presented are:

- **New bulk buy-out players:** the entry of these organizations to the market – Goldman Sachs and Paternoster are prominent names – should lead to greater competition in the terms being offered. It should also be possible to buy-out larger amounts – in future buy-outs of liabilities well in excess of £1bn should be achievable and indeed there is likely to be more competition for larger deals.
- **Partial buy-outs:** these are a ‘half-way house’ where the DB provision is retained by the company but elements of the risk are offloaded to an insurer.
- **Non-insured buy-outs:** such approaches offer the severance of pension risk from the sponsoring company but without the full security of an authorised life assurer.

Alternatives to buy-out – what are the risks?

The issues surrounding these alternative options are varied and complex – it is vital to understand the provider's value proposition as well as that of the alternatives, undertake due diligence on providers, engage with the trustees and, potentially, negotiate with the Pensions Regulator. On this latter point, the Regulator has recently issued a statement expressing support for innovation in managing pension liabilities, but also voicing concern that companies should not easily be able to abandon their schemes without payment of the full "section 75" debt.

Some approaches may in fact increase the risk to the employer by obstructing its ability to subsequently restructure the scheme, its benefits, or even ultimately to wind up the scheme. Before adopting any of these alternative strategies, companies will need to review the structure and risks very carefully.

Another alternative – return seeking run-off

Non-insured buy outs allow the provider to profit from having more freedom than an insurance company. Companies could use the same techniques as these providers to optimise ongoing pension scheme management. Such techniques could include:

- Outsourcing components such as administration and trusteeship to 'best of breed' providers to access the required skills
- Innovative approaches to investment strategy such as liability-driven investment
- Governance structures to allow employers more control of funding and investment strategy.

How can we help?

Watson Wyatt is able to harness expertise in pension, insurance, investment and administration, to advise companies on all the areas that would need to be addressed.

We would be happy to explore these matters in greater depth with you, helping you to develop a clear understanding of your position and options, in light of your objectives and current scheme design.

To find out more, please contact your Watson Wyatt consultant or call Steven Dicker on 0161 839 1600 or Andrew Reid on 020 7222 8033.

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